Financing in rural areas

# Microcredit at its limits

*«A worrying scenario is emerging, with credit fleeing rural areas». This is how a famous 1950s article on agriculture begins. It was not describing Africa or Latin America, but Germany. The issue is not a new one in the development of financial systems, but it remains unresolved in the development policy context.*

Photo: Egbert

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To date, the hope that microfinance institutions (MFIs) would expand into rural areas following their success in the cities has only been partially fulfilled. This fact puts into better perspective parts of the theory that the subsidized and directed agricultural credit of the past were the main obstacle to the emergence of new, market-oriented financial institutions. The absence of development impact generated by the Latin American and African agricultural development banks, which have now been closed, has been well documented. However, the challenges presented by rural finance now appear to be more complex. The market distortions of the past alone cannot explain the absence of credit in rural areas. Where state banks have closed, the institutional landscape is still very sparsely populated (See also the article by H.D. Seibel in this issue).

What are the reasons behind the particular challenges facing rural areas? Why are the greatest success stories among private-sector MFIs (cf. the Top 100 of microfinance in the internet portal The Mix Market) so strongly concentrated in urban areas and in trade and consumer affairs? It is as if walls divide these MFIs from those in rural areas: twin walls built of risks and costs.

Microfinance includes microcredit, savings services for poorer people, payment transactions and remittances (including those between family members) and limited insurance services. In all four sectors, rural areas represent a particular challenge, to which so far only a few, mainly public or self-help institutions have risen.

Microcredit would certainly be an important product in rural areas. As in the urban informal sector, many rural households use different sources of income to offset their risks. Short-term, flexible loans can help to smooth income streams over time and thereby contribute to poverty reduction. Rural areas nevertheless also impose limits on microcredit techniques and require loan products which, so far, many MFIs are unable to offer. Agriculture – production, processing and marketing – is still the key focus of activity in rural areas. Financial institutions, however, shy away from a one-sided focus on a single sector and always look to balance risks. In this regard, rural areas offer fewer alternatives than the city. Microcredit techniques also require a fast turnover of capital. The short-term loans and even shorter repayment periods, repeated in quick succession, are not particularly compatible with agricultural production processes. The cycles of plantation farming, sometimes lasting decades, and even the seasonal cycles of most plant-based agricultural products are not compatible with micro loan techniques, which require close and regular contact with customers. Agricultural loans are not normally small or quickly repayable. Agricultural credits are not microcredits.

There are certainly exceptions, where micro loans can also play an important role for farms. Examples include poultry production and holdings with other sources of income or a broad range of

## China's post bank

The Chinese Postal Savings and Remittance Bureau, established in 1986, is part of China Post and, with savings deposits of approximately EUR 90 billion, holds almost ten percent of all China's savings deposits. Three quarters of its some 30,000 branches are located in rural areas. Approximately half of its 250 million customers are from poorer households. The postal savings system is a crucial factor in maintaining contact between poorer rural households and the millions of migrant workers in the cities. According to estimates, around half of all rural income already comes from financial remittances from the booming cities. In addition to this redistributive function between cities and rural areas, the savings services provided by the post bank also stabilize the income of private households. The post bank is not yet permitted to issue loans, although comprehensive reforms had been announced for 2005.

Photo: E Egbert

**Self-help is necessary wherever no adequate public financial infrastructure is available – it can come in the form of informal savings and loan groups, cooperatives or village banks.**

agricultural products. Such farms do not usually require specifically agricultural loans, with the repayment periods these entail, and can make equally good use of microcredits. Clearly, however, they only have a limited potential for growth, since the broad diversity of agricultural activities prevents the necessary modernization and professionalization of the agricultural sector. While small farms with ten different products or income sources are better insured against price fluctuations and the vagaries of nature, there are few opportunities for growth and development. To a certain extent, they even contribute to the weakness of the agricultural sector because of their low productivity and lack of supply elasticity.

The limited ability of small farms to finance high effective rates of interest is another factor restricting the expansion of MFIs into rural areas. Interest rates can be paid for short-term trading activities that would be unthinkable in production circumstances. The low customer density and higher transaction costs in the rural areas of countries such as Bolivia or Mongolia are an additional factor that anchors most MFIs which obey market forces in the cities.

## A pluralistic financial sector

But let us now turn to positive experiences and solutions. A multitude of institutions and innovations provide the trumpets to bring down the above-mentioned walls of Jericho. However, many of these institutions have so far received little attention from donors. Recent analysis by the multi-donor forum CGAP (Consultative Group to Assist the Poor) has revealed which microfinance institutions are most effective in reaching large numbers of people. It is hardly surprising that China Post is one of the largest financial institutions in the world, with 250 million savers. What is rather more surprising, however, is that its customers include very many members of poorer target groups in rural areas, and yet so far hardly a single donor has discovered postal savings banks. The oft-cited and well-supported NGO-based MFIs or the Greenfield Banks only cover approximately 15 percent of the market for global microfinance services (including savings services). They lie far behind the public development banks and postal savings banks in terms of importance (cf. CGAP, *Financial Institutions with a Double Bottom Line,* 2004).

The rural financial system has become a particular problem in those countries where the state has completely abandoned providing any financial infrastructure. Following the withdrawal of the state, national governments, on the advice of many donors, had hoped there would be a level playing field for new entrants to the financial markets. Unfortunately, this is very rarely the case. Asia is almost the only continent where countries have retained a role for the state in providing rural areas with financial services – not through subsidized interest for loans, but by providing services for savings and payment transactions. Postal savings banks and reformed agricultural development banks, such as BRI in Indonesia, Bank Pertanian Malaysia or BAAC in Thailand (which is supported by the GTZ), are part of this movement. These services meant it was possible to cope with the necessary shift to the cities without cutting ties between the rural areas and the higher-earning migrant workers in the cities. No doubt these institutions will not be able to supply the answer to the lack of private-sector players in all countries. In many African countries, due to the break-up of the state, community self-help through informal savings and loan groups, cooperatives or village banks appears to be the only solution, with all the problems associated with a lack of linkages that often accompany such self-help. Yet here, too, there is recognition that support for institutional diversity is an important step towards solving the specific problems of rural areas. In countries with vast territories, the provision of financial infrastructure must either become a national responsibility, or mechanisms such as cross subsidies must be used (as often employed for national postal systems).

## Is agricultural credit too risky?

Public infrastructure can chiefly support services for savings and payment transactions in rural areas. When it comes to the allocation of loans, however, the old weaknesses of the public system emerge once again. This is reason enough to prohibit most postal savings banks from engaging in the loan business and not to have blind faith in many agricultural development banks. As already stated, loans in rural areas are mainly, but not exclusively, agricultural loans. New ideas are needed to help banks overcome their fear of the agricultural sector. While banks cannot make this sector more profitable, they can help to alleviate risks and thereby remove the walls separating the financial and agricultural sectors.

The World Bank is currently supporting a number of pilot projects involving insurance for agricultural loans and the use of futures markets. The index-based agricultural loan insurance links the insured event to the overall weather data for a region. Compensation is paid if, for example, the amount of precipitation falls below a specific level. Whether or not the event affected each farmer is incidental. These mechanisms help avoid cases of insurance fraud and the high costs associated with investigating damages, which in the past ruined almost all agricultural insurance schemes. In contrast to traditional agricultural insurance schemes, these new schemes insure only the loan and not the harvest.

For agricultural products traded internationally, banks and loan recipients can insure themselves against price fluctuations using the futures markets. In principle, this method is identical to that used by exporters to hedge against exchange rate fluctuations. A few prerequisites are necessary, such as a very close correlation between prices on futures markets and national prices, as well as the long-term stability of world market prices. Unfortunately, futures and put options do not help against significant downward trends over longer periods. However, at a small additional cost, the risks of some price fluctuations can be minimized in this way (J.R. Skees: *Risk Management Challenges in Rural Financial Markets*, 2003).
In both cases – agricultural loan insurance and futures markets – it is up to the banks to design the products in a way their customers understand. The mechanisms, which are somewhat complicated, must be concealed behind simple insurance schemes. In future, donors could play an innovative role in developing these products, as they have done in microfinance.

Photo: Sparkassenstiftung

**A system like the German Sparkassen system, which is closely connected to a local community by its ownership structures and overall set-up, is one recommendable solution.**

## High transaction costs

Approaches that succeed in rural regions of Bangladesh or Szechuan Province do not necessarily work successfully in the Andes or in the Sahara. While it might create headaches for demographers, a high population density is often a blessing for bankers. In densely populated regions, branches can work profitably and products can be tailor-made. In sparsely populated areas, high transaction costs are a barrier to the expansion of the financial services frontier.
The role the state can play in financing rural financial infrastructure has already been discussed above. In addition, there are a number of interesting approaches to reducing costs through mobile banks (these could be motorcyclists) and the use of modern information technology. It is doubtful whether a solitary ATM or cash machine in the Mongolian Altai Mountains is really the right solution, or whether internet or mobile phone banking will bring a farmer closer to the financial sector. Nevertheless, this area certainly has potential, which is determined by various factors:

- the security situation, and with it the costs for permanent and mobile branches in rural areas,
- the degree to which the rural population is organized – producer associations can be more easily integrated than individual farmers,
- cross-subsidization through a major national network of branches,
- government incentives, for example to lower the barriers for banks to enter the market.

For instance, the capital requirements for Indonesian community banks (Bank Perkreditan Rakyat) in rural areas are only a quarter of those for banks in Jakarta. Thailand and India have been using legal force for decades to require that commercial banks base a specific proportion of their loan portfolios in rural areas. This has been frequently criticized from a textbook economic perspective, as it encourages bureaucracy and fraud.
A system like the German Sparkassen system, which is closely connected to a local community by its ownership structures and overall set-up, is certainly preferable. To a large extent, Germany's very balanced regional development can be traced back to this system. However, this model cannot easily be exported as such, because most developing countries do not have the same level of political decentralization and democratization.

## What about the lack of collateral?

The automatic reaction in the past has been to pinpoint the problem of the lack of land ownership among the rural poor. But this reaction fails to recognize that the situation of the poor in the cities was and is no better, and yet microfinance has lead to a significant improvement in the availability of loans there. Ever since microfinance has existed, advisors have been trying to persuade banks to let go of their traditional approach of securing loans through collateral, instead using the customer's ability and willingness to make repayments as the basis for loan decisions.
Although agricultural loans are not microcredit, they can nevertheless utilize some of the same techniques. In concrete terms, this means looking for alternatives to traditional forms of collateral. Warehouses, suppliers, traders and processors can play a new role in the creative securing of loans or even directly replace financial institutions. Financing gaps can be identified by making a detailed analysis of the value chains for different agricultural products, and solutions can be found through a combination of formal and informal financing.
One major difference between microcredit and agricultural credit is that with the latter the financial and agricultural sectors are tightly linked. Unless both sectors are analyzed, the question of whether banks are too risk-averse or cumbersome, or whether agriculture is too unprofitable, will remain unanswered. The truth, and with it the challenge of rural financing, lies somewhere in between the two.